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DISCLOSURE THROUGH A GLASS DARKLY

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In some respects, my appearance on this program is like a fifth wheel on a vehicle. The other participants are either associated with a bank or a bank regulatory agency, and from that vantage point have discussed the practices, policies, responsibilities, statutory alternatives, and limitations of bank agencies as they attempt to assist banks which have serious operational problems. Comments of the speakers today, as well as earlier public accounts of the steps taken by bank regulators in connection with the failures of the United States National Bank of San Diego ("U. S. National Bank") and the Franklin National Bank ("Franklin"), illustrate the difficult decisions which confront bank agencies as they endeavor to promote and preserve public confidence in banks.

There is little doubt that bank crises challenge bank regulators and tax their abilities, even when facts regarding the condition of the bank or actions taken by the regulators to protect the bank and its depositors are not publicly disclosed. It is only natural, therefore, that bank regulators seriously question the extent to which the Securities and Exchange Commission, with its statutory mandate to protect investors by requiring full and fair disclosure, should be involved in such situations.

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I have the highest respect for the integrity, capability, and public dedication of banking agency officials, and my purpose is not to suggest that the responsibilities of the SEC to investors and the securities markets supersede those of the bank agencies to depositors and the banking system. Nor is it my purpose to praise or to criticize the actions of bank regulators in the Franklin or U. S. National Bank cases. My purpose is to discuss SEC involvement in these bank failure cases, the basic conflicts which exist between the purposes and policies of the Commission and bank agencies, and to suggest that not only is it unnecessary to withhold material information regarding bank operations from the public in order to promote and preserve confidence in banks, but that, in the long run, the best means of promoting and preserving confidence in banks is full and fair disclosure.

I believe a discussion of the conflicting bank agency and SEC philosophies and responsibilities is timely because federal regulatory agencies are being carefully scrutinized by the White House, the Congress, and the public. I do not know the extent to which these critiques include the bank agencies, but I do know that their practices are being seriously questioned. A critical view of independent regulatory agencies in general is expressed in an article in the July issue of the Readers Digest entitled, "Our Rotting Fourth Branch," which has been inserted in the Congressional

Record along with comments by several members of Congress. In early July, President Ford invited members of various federal agencies to the White House to discuss regulatory purposes and functions. In addition, late in July, the SEC and other regulatory agencies responded to a comprehensive Congressional questionnaire regarding all aspects of their activities.

Regulatory agencies are being reexamined to determine whether their actions protect the public, as mandated by statute, or promote the interests of those they regulate; whether their activities contribute to an economic environment in which private firms may operate competitively while maintaining business standards beneficial to the public; whether regulation has resulted in higher prices to the public and less incentive for cost control and innovation by business enterprises; and whether the costs of regulation outweigh its benefits. While I cannot agree with the suggestion that regulatory agencies should be abolished automatically after a 10-year life span, I believe that their operations should be reviewed periodically to determine whether the goals and objectives for which they were established are still meaningful and in the public interest, and, if they are, whether agencies are operating in a manner that effectively and efficiently fulfills those goals and objectives.

The Franklin and U. S. National Bank failures provide case studies from which to review the role of the bank agencies and the SEC in protecting the public interest. The SEC became

involved with the U. S. National Bank problems during an investigation of the conglomerate Westgate-California Corporation ("Westgate"). The Commission's investigation established that Westgate manipulated earnings through a series of friendly transactions between the bank and what appeared to be independent companies, but which were related through nominee ownership and other corporate arrangements. These companies obtained substantial improper loans which seriously weakened the bank's financial structure, and these transactions led the Commission's staff to recommend that the bank be named along with other participants as a defendant in an injunctive action for violations of the federal securities laws.

Consistent with the Commission's policy of giving the bank agencies advance notice of proposed Commission actions involving banks, we notified the Office of the Comptroller of the Currency ("Comptroller's Office") of this recommendation. The Comptroller's Office did not object to the lawsuit, but expressed opposition to naming the bank as a defendant because of the danger that the publicity of the lawsuit would cause a "run" on the bank. While the Commission was sympathetic to that problem, we insisted that the bank would be named if the Comptroller's Office did not exercise its cease and desist powers against the bank and one of its officers. Such an order was issued on May 24, 1973. We also insisted that the cease and desist order be publicly announced

to inform investors, and we indicated that we would suspend trading in the bank's stock until such information was made available to the public. In response, on May 31, 1973, the Comptroller's Office issued a press release describing the cease and desist order concurrent with the filing of the Commission's injunctive action, which did not name the bank as a respondent.

The first SEC involvement with the Franklin problem came on Thursday, May 9, 1974, when rumors circulating in the financial community about the bank were brought to our attention. The price of the stock of Franklin New York Corporation, the bank's holding company, had fallen from a close of 14 on May 6, to 11 3/4 on May 8, and was quoted as low as 8 3/4 on May 9. These events caused our staff to undertake an informal inquiry to determine whether the holding company contemplated a public release describing corporate developments, if any, that might account for the movement in the company's stock.

On Friday morning, May 10, the Comptroller's Office called us about the questions we were asking the company, what information we had received about the bank, and requested that we confer with them concerning Commission actions because of the sensitivity of the situation. We agreed to cooperate and coordinate our efforts with the bank agencies.

Later that morning, in response to our staff inquiry, company counsel informed us that the company might forego its annual dividend and that a decision on that matter would likely be made on the following Thursday. Counsel also indicated that, while some of the rumors about the company were unfounded, others, including the "possibility" that Franklin might realize a loss in the second quarter, appeared to have a factual basis. Upon receiving this information, the Commission's first concern was whether trading should be suspended in the securities of the holding company and the bank because current and accurate financial information was not publicly available. We discussed with company counsel the issuance of a press release to clarify the situation. We also consulted with the bank regulatory agencies and indicated that we were seriously considering a trading suspension. During that discussion, we received additional information about the bank such as amounts due to foreign banks, amounts in CD's of $100,000 and over, and the net federal funds position.

The bank agencies expressed the hope that the Commission would not find it necessary to suspend trading because such an action so soon after the U. S. National Bank failure could cause a run on the bank by depositors and send tremors throughout the entire banking system. In response, we suggested that a trading suspension might not be necessary

if the company would quickly issue a public statement making full and fair disclosure as we had recommended.

On the basis of the banking agencies' opposition to a trading suspension, their representation that they would have some of their top people working on the problem in New York over the weekend, and company counsel's agreement to issue a press release, which was carried by the major news services at 1:55 p.m., the Commission determined not to suspend trading, but to wait for the results of bank agency investigations over the weekend. Later in the afternoon of Friday, May 10, we received reports of possible insider trading by bank employees. We decided that these reports, along with earlier indications that there may have been failures to report accurately and currently financial developments within the holding company, and possible embezzlement or looting of corporate funds, provided an adequate basis for authorizing a private order of investigation invoking subpoena power to gather additional facts relating to possible securities laws violations.

By the afternoon of Sunday, the 12th, reports from bank regulators and senior staff members of our New York Regional Office indicated that the bank had several rather serious problems which could not be accurately quantified without an extensive review of its operations. In addition, counsel informed us that they had resigned because they had not been included in the company discussions or decisions

which had occurred during the day. It became clear that the information necessary for prudent investment decisions had not been disclosed and could not be disclosed accurately to investors at that time.

Although the company proposed to issue a general release describing its problems and plans to solve those problems, the Commission determined late Sunday evening that a suspension of trading in the securities of the holding company and the bank was necessary and appropriate to protect investors. Under our suspension authority, the Commission may suspend trading for a period not to exceed ten days, and, at the end of that period, new suspensions may be initiated for additional ten day periods as necessary and appropriate. In this instance, the banking authorities requested that, if the Commission were to determine that a suspension was necessary, that it be for a period shorter than the full ten days because a ten day suspension could be interpreted as portraying a more serious problem than a shorter suspension. We responded that, if a short suspension were not adequate, a public announcement of a further suspension of the securities would be required, and this might have a more negative effect on bank depositors than a normal ten day suspension which could be terminated, if appropriate, before the end of the ten day period. Nevertheless, the Commission acquiesced to the desire of bank agencies to minimize the initial impact

and suspended trading for a 48 hour period. Trading was suspended again at the end of that two day period, and additional suspensions were initiated at ten day intervals for several months until October 31, 1974.

During the next few months, our staff, with the cooperation of the bank agencies, undertook a very detailed investigation of the operations of Franklin and the holding company. A report of the staff's preliminary findings was made available to the banking agencies and reviewed with them at a meeting on September 3, 1974. At that meeting, bank regulators recommended that, if possible, the Commission should withhold enforcement action until an appropriate resolution had been worked out for the bank, however, there was no assurance when such a resolution could be finalized. We acknowledged that it would be disruptive to file an action just before final arrangements were made and agreed to keep the bank regulators informed of the Commission's progress in reaching a final enforcement decision. We also asked that we be kept informed on progress made by the bank agencies because Franklin's trust department was performing bookkeeping operations for several brokerage firms, and we wanted the resolution of the bank problems to include arrangements that would avoid interrupting those services.

Our staff continued its investigation, and on October 17, 1974, shortly after Franklin was declared

insolvent by the Comptroller of the Currency and purchase and assumption arrangements had been completed, the Commission filed an injunctive action. It was argued that it would be inappropriate to name the bank since it was insolvent and would not exist as a separate entity. The Commission agreed not to name the bank, but its complaint described in detail the bank's conduct in order to inform the public that the bank's activities contributed to the alleged violations of the securities laws.

These failing bank cases emphasize the fundamental policy differences between the regulatory approaches of the SEC and the bank agencies. These differences are attributable, at least in part, to the mandates of the banking and securities statutes. Bank agencies are charged with promoting and preserving the soundness of the banking system, and have historically relied on non-public regulatory procedures because publicity regarding banking problems is considered to be inconsistent with promoting a sound banking system. On the other hand, a basic underlying philosophy of the securities laws is public disclosure, and, although SEC investigations are normally private and the Commission may institute private administrative proceedings where special considerations are present, our enforcement program is generally conducted through public administrative proceedings and court actions.

A simple solution to these conflicting approaches would be to give one precedence over the other. However, both have some merit, and the temptation to suggest that one is always preferable to the other should be resisted. When a bank's operations deteriorate until the salvage efforts of bank regulators are required in order to protect depositors and maintain confidence in the banking system and no disclosure has been made of these facts, perhaps it is inappropriate to name the bank in an injunctive action if it is likely to precipitate a run on the bank by depositors and make it more difficult for bank regulators to resolve the banking problems successfully. Saving a bank from massive withdrawals and consummating a satisfactory takeover may be in the interests not only of depositors, but of bank shareholders as well.

A review of recent SEC enforcement activities involving securities violations by banks reveals a consistent pattern of consultation with bank regulatory agencies before public action is taken by the Commission. In some instances, bank agencies have not objected to the naming of a bank in an injunctive action or a public administrative proceeding. When bank agencies have opposed such actions, sometimes the Commission has, nevertheless, named the bank and sometimes it has insisted, as a condition for not naming a bank, that the bank agency take effective action, such as issuing cease and desist orders, announcing publicly such orders, and removing bank officers.

Securities laws require the Commission to act as "necessary or appropriate in the public interest or for the protection of investors." While the two separate elements of this responsibility are usually consistent, they are not necessarily synonymous. In instances where banking agencies believe that there is a strong possibility that a Commission enforcement action would jeopardize the solvency of a bank and be adverse to the other public interests, such as a sound banking system, the Commission, after weighing all the considerations, may determine that it is appropriate to adjust our proposed enforcement action. However, even in these circumstances, the Commission attempts to assure that, consistent with the overall public interest, investor protections are provided to the maximum extent possible.

The SEC's insistence in naming U. S. National Bank in an injunctive action unless appropriate bank agency enforcement action was taken and publicly disclosed, not only provided information to investors, but also assisted the bank agency in obtaining a consent to its cease and desist order. Furthermore, the Commission's injunctive action was the most effective method of halting the unlawful conduct and unsound practices that had been occurring since at least 1969 and prevented further deterioration of both bank and corporate assets. In the Franklin case, although the Commission refrained from filing an injunctive action until

after arrangements satisfactory to the bank regulatory agencies had been made with respect to the assets and business of the bank, we did require certain disclosures by the company in order that investors would be informed, and, when it became evident to us that full and accurate disclosure could not be made, we suspended trading in the company and bank securities.

Despite our efforts to minimize the adverse effects that our actions might have on banking interests, neither the bank agencies nor the SEC have been completely satisfied with these "compromises." One staff member of a bank regulatory agency expressed a strong view that, "Perhaps neither Franklin or U. S. National could ever have been saved--that is not clear." "What I believe is clear," he continued, "is that once the securities laws came into play, saving them was impossible."

It may well be that at the present time, even with the best of intentions, the conflicts in purpose, philosophy, and regulatory approach between bank agencies and the SEC cannot be accommodated completely in the context of a bank failure. I believe it is obvious, however, that neither the securities laws nor actions under those laws caused the failure of Franklin or U. S. National Bank. On numerous occasions, the Commission has named banks either in injunctive actions or public administrative proceedings without causing their failure or irreparable harm to the banks or the banking

system. At one time, both Franklin and U. S. National Bank were apparently very sound institutions, and, if effective action had been taken earlier in their decline, there is a strong probability that both banks would be alive and well today.

The Commission does not bring actions against banks without careful deliberation. It is difficult, however, to determine the net public interest when the factors being considered are so intangible and immeasurable as the probability of a run on a bank, the benefits involved in assuring that depositors and investors obtain material information about bank operations, and the effects that these alternatives could have on public confidence in the banking system and in the securities markets.

Perhaps the banking and securities statutes need to be amended in order to reduce the conflicts and uncertainty involved in such decisions, but even in the absence of legislative changes, agencies have some administrative flexibility in the approach that is taken to fulfill their statutory responsibilties. To the extent a reconciliation of existing conflicts can be obtained through such flexibility, the effectiveness of our efforts should be enhanced.

I believe that, considering the general tenor of our times and the stress that is being placed on assuring that the public is informed, it is in the public interest to reduce

the conflicts between the SEC and the bank agencies by more meaningful disclosure of bank operations and the activities of bank agencies. Furthermore, I would like to explain why I believe these changes will be beneficial to banks, the banking system, and the general public. While the concept of withholding information concerning bank operations and bank regulatory action may have been helpful in fostering and preserving confidence in banks in the past, it doesn't necessarily have that effect today. As long as there were no major bank failures, it was reasonable to assume that, although the actions of bank regulators were non-public, surely they were doing whatever was necessary to assure that banks operated in a safe and sound manner. However, there can be little doubt that recent, large bank failures have given investors and depositors reason to question whether their confidence in banks or in the effectiveness of bank regulation is merited.

What one may imagine on the basis of partial information, knowing that some information has been intentionally withheld, is usually worse than the actual facts. There should be no question that most banks are well managed and present no reason for either shareholder or depositor concern, and that, although bank regulators are not omnipotent, they attempt to assure that banks comply with banking laws, rules and regulations. Nevertheless, there are

problem banks, and, according to public reports, the number of banks in this category during the last year is greater than at any time in the recent past. Realizing that there are such banks, but not having information publicly available on which to judge which ones they may be, could make investors believe that investing in a bank is something like Russian roulette.

One indication of dissatisfaction with bank regulatory conduct is the Westgate trustee's recent notice of a cause of action under the Federal Tort Claims Act against the United States and its agents, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Federal Reserve Board, alleging, among other things, negligent conduct in administering the banking statutes. Regardless of what the merits of this case may be, the policy of non-disclosure makes it difficult, if not impossible, to demonstrate that bank regulators do take effective action and that the banking system is strong and healthy.

I believe that confidence in banks would be promoted and preserved if more information regarding the operations of individual banks and regulatory actions against banks were publicly disclosed. Not only would this be valuable to depositors and shareholders who could then base their decisions on a better understanding of the condition of the bank, but public disclosure would also provide a strong incentive for management to comply with safe and sound banking practices in

order to merit the confidence of investors, depositors, and the general public. Such disclosure would benefit strong, well managed banks which, I believe, are being penalized under the present system because they are unable to indicate clearly that they do not have problems. It would also make it more difficult for weak or badly managed banks to retain an unwarranted measure of shareholder and depositor confidence which they may have now by avoiding disclosure.

Full and fair disclosure will also be beneficial to prospective depositors and shareholders who have at least an equal right to protection as do present depositors and shareholders. We cannot ignore the fact that during the years that U. S. National Bank was having substantial internal operational problems and was becoming less and less viable, unwary depositors were being encouraged to deposit their savings, and many investors purchased stock in the holding company unaware of the bank's problems. Of course, any insider who knows of such problems and who sells stock or encourages deposits may be engaged in fraudulent conduct. In my opinion, the banking agencies and the SEC must exercise whatever powers we have to meet these types of problems if we are to fulfill our responsibility to the banking system and the investing public.

Toward that end, late last year after consultation with the bank agencies, the Commission issued Accounting Series Release 166 to inform banks and others of their responsibilities to disclose unusual risks and uncertainties in their operations under changing economic conditions. The Commission's effort to obtain more meaningful disclosure from banks met with strong banking opposition and argument that the type of disclosure the Commission was requesting would be misleading to investors, would not be understood, and would impede banks in raising necessary capital in our markets. However, we have also received strong support from many persons, including key members of Congressional Committees having jurisdiction over banks, the bank agencies, and the SEC, who must believe that such disclosure will assist the Commission and the banking agencies to serve more fully the public interest. We have already obtained additional disclosure in registration statements and periodic reports by holding companies and affiliated banks, and experience with the additional disclosure has demonstrated that the fears of bank holding companies and others were not well founded. Since the issuance of Accounting Series Release 166 on December 23, 1974, over thirty bank holding companies have met the Commission's disclosure requirements in registration statements and have had successful underwritings. These underwritings range from small offerings of $1 million to Citicorp's offering of $350 million. One of the most recent offerings was Crocker National Corporation's

issue of $33 million of equity securities which was oversubscribed and was completely sold on the day it went effective.

In order to be as helpful as possible in providing bank holding company registrants with disclosure guidance, a group of bank agency and SEC representatives has been working since last April to develop and recommend disclosure policy guidelines, and we appreciate the assistance of the bank agencies in this drafting effort. The group has not yet reached complete agreement with respect to appropriate minimum disclosure standards that will be recommended, but much progress has been made, and the Commission should be able to publish proposed guidelines for public comment within the next few weeks. If there are areas of strong disagreement remaining between the Commission and bank agencies at that time, we may ask for comments on alternative disclosure approaches.

As the disclosure of more facts about the condition of banks becomes a routine practice in registration statements and periodic reports filed with the Commission, the Commission and bank regulators should have far fewer occasions when our mandates conflict with each other, because there should be fewer instances when Commission action against banks is necessary, and, when such occasions do arise, the fact that the public would already be aware of the situation should significantly reduce, if not eliminate, the concern that Commission action would precipitate a run on the bank.

Winds of change are blowing across the entire structure of regulatory mechanisms and functions in this country. These winds touch all regulatory agencies, and more meaningful disclosure in banking is an example of such changes. Whereas bank operations are now seen as through a glass, darkly; with full disclosure, they would be seen as they are. Such disclosure will be beneficial, both to those who entrust banks with their savings and demand deposits, and also to investors who provide the capital necessary for bank operations and expansion.